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February Primary Auction Note

Date: 15 February 2019

Recommendation:
Bid **11.35%** to **11.60%** for **FXD 1/2019/5**

Bid **12.25%** to **12.50%** for **FXD 1/2019/10**

Sovereign Credit Rating (outlook):
Moody's: *B2 (stable)*
Fitch: *B+ (stable)*
S&P: *B+ (stable)*

Jan CPI: (2009=100)
185.47

January Inflation:
4.70%

Interbank rate (14/02/19):
1.2352%

C.B.R :
9.00%

91-Day T-Bill:
7.016%

182-Day T-Bill:
8.483%

364-Day T-Bill:
9.551%

Analyst

Victor Koech
+254711047133

koechv@aibcapital.com

In February the CBK is offering for auction, two fixed income bonds. A **10-year bond** (**FXD 1/2019/10**) and a **5-year bond (FXD 1/2019/5)** to raise a total of **KES 50 billion** (**USD 497.96 million**) for budgetary support. The two bonds have coupon rates that are market determined.

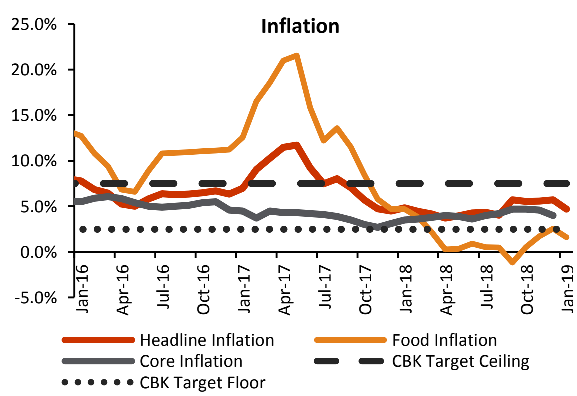
In the current market condition of high liquidity, the shorter term or the **5-year** fixed coupon bond may garner more attention from the market. In contrast with the **5-year** paper, the **10-year** might receive lukewarm reception at the auction. We expect moderate to high subscriptions for the **5-year bond** and we, therefore, prescribe investors to bid within the **11.3500%** to **11.600%** range. Those investors who find the **10-year** bond suitable, we recommend investors to bid within the range of **12.250%** to **12.500%.**

Interest rates are currently on a slide brought about by the current high money market liquidity. High liquidity amid market uncertainty continues to drive high T-Bill subscriptions. Liquidity in the market has been helped on by government payments and net redemptions over the last two month. This liquidity, we caution investors, may make the CBK more discerning especially around the **5-year** bond.

The risk for the rise of interest rates in the medium term still exists. Upward risks will continue to be elevated as long as the government continues to take on an expansionary fiscal stance despite perennial challenges in collecting tax revenues. Even though the government continues to project fiscal consolidation, fiscal slippage is the most likely outcome.

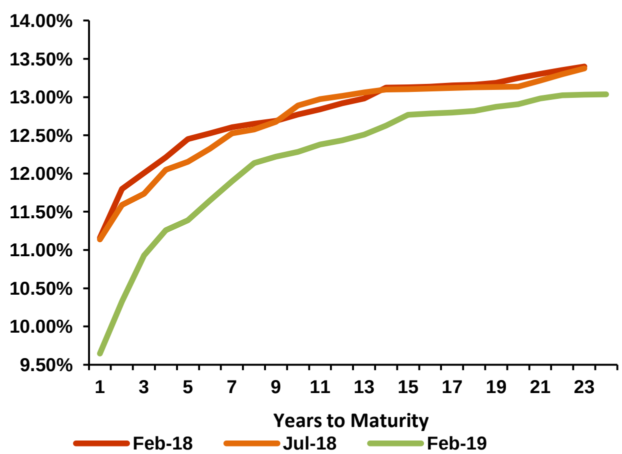
Secondary Bond Market: In February, the remarkable growth in activity in the secondary market continued. Turnover during the first seven trading days of February firmed up by **33%** to **KES 15.33 Billion** (**USD 429.7 Million**) from **KES 11.55 Billion** (**USD 115.3 Million**) recorded in the same period in January. Turnover in February was propelled by the re-open of the **2-year** and **15-year** in the period under review. High investor interest around the **5-year** FXDs, **10-year** FXDs and **15-year** FXDs also helped activity accelerate over February.

January Inflation: CPI weakened over January driven by a decline in the prices of foodstuffs and a decline in the transport index. Headline inflation in January frittered down to a five-month low of **4.70%** from **5.71%** recorded in December. Good weather and improved agricultural production have provided strong headwinds that have slowed food inflation. The decline in prices of foodstuff namely: maize flour, sugar and beans inspired the food index to only increase by **1.62%** down from **2.54%** recorded in December. Subdued petroleum prices also pushed the Transport index inflation from the **14.3%** registered in December production to **11.1%.**



Interbank: In February, the money market liquidity continued putting downward pressure on the interbank rate. In the first 12 days of February, the average monthly interbank rate fell to **2.728%,** a decline from January's average monthly interbank rate of **3.52%**. The average volume traded also declined to **KES 9.3Bn** from the average volume traded of **KES 10.7Bn** in January.

T-Bills: During the month of February T-bill auction's subscriptions remained high. The first two auctions in the month of February registered the average performance rate of **183%,** relatively flat from the average performance rate of **188%** recorded in January**.** High liquidity in the market drove oversubscriptions for the **182-day** and **364-day** T-Bill auctions. The most sought short term paper still is the **364-Day** T-Bill that recorded an average subscription level of **295%** at the two auctions in February. We advise those investors who wish to remain short, to manage interest rate uncertainty, to maximize their yield by investing in the **364-Day** T-Bill.



NSE Yield Curve: The current yield curve, (**08/02/2018**), continued to exhibit a downward shift in the short and long-term key rates. Short term rates have fallen further than the long term key rates, steepening the yield curve. The steepening of the yield curve has firmed up the spread between the 1-year bond and the 24-year bond from **227.8bps** in December to a current February spread of **339.4bps**.

Over the month of February, the NSE yield curve slid further lower. The one year end of the yield curve is down **151.5bps** from December levels to yield **9.6440%** as high investor demand on the shorter end continues to manifest. The longer end fell slower during the period under review, the 23-year bond yield is weaker by **40.6bps** to currently yield **13.0375%**.mostly driven by demand on the longer-dated IFBs. The bond yields could continue to steepen as a consequence of increased demand on the short end of the yield curve. Active managers should consider decreasing their bond portfolio duration by investing mainly in short term bonds to outperform.

Currency: The Kenya Shilling gained some ground against most major currencies in February. The dollar continued to lose value against the Kenya shilling. The greenback lost **0.65%** in February to currently stand at **100.2400/KES** from the **100.8900/KES** recorded at the end of January**.** The Kenyan Shilling also continues to enjoy tailwinds from firm export performance, strong remittances and investment flows amid a decline in import demand over the month of February.

Usable foreign exchange reserves in January closed out strong and untested. The reserve on the 7th of February stood at **USD 8,232Bn**, a **1.2%** improvement from the **USD 8,136Bn** recorded at the end of January. The current foreign exchange reserves translate to about **5.39 months** of import cover flat from the 31st January import cover of **5.33 months**. The stability of the shilling in 2019 we reiterate will be determined by the government's ability to refinance existing debt. A syndicated loan and a 5-year Eurobond will mature in 2019. The currency in the medium term may be supported by increases diaspora remittance, increased tourism and the low international price of crude oil.

AIB Capital Research

Research Team,

Head of Research
Sarah Wanga
wangas@aibcapital.com
(+254) 711047105

Research Analyst
Victor Koech
koechv@aibcapital.com
(+254) 711047133

Equity Dealing Desk

Chief Dealer,
AIB Capital Equities
Bernard Kung'u
kungub@aibcapital.com
(+254) 711047108

Head of Institutional Trading,
AIB Capital Equities
Bernard Gichuru
gichurub@aibcapital.com
(+254) 711047111

Equities and Derivatives trader,
AIB Capital Equities
Brian Tanui
tanuib@aibcapital.com
(+254) 711047124

Bond Dealing Desk

Crispus Otieno
otienoc@aibcapital.com
(+254) 711047113

Titus Marenye
marenyet@aibcapital.com
(+254) 711047118

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